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**WHY BUY VALUE?**

The commentary below was put together post the reporting season and partly in response to some stocks moving to eye watering P/Es. While most companies struggled to find growth, there were a select few good companies that did have growth and so continued to be re-rated. This investment rend became known as GAAP (Growth at any price) but is not a new phenomenon, it seems it is just another natural part of the market cycle.

**Be careful buying at above 25x** Goldman's found that since 2001, buying Industrial stocks trading on more than 25x forward earnings has generated an average return of -5% over the following 12 months versus an average annual gain of the market of 10%. Not only that but in the event one of these stocks really has a miss-hap, the potential downside via p/e de-rating is enormous and well outside our risk tolerance.

A high starting valuation tends to provide an immediate headwind (-4% vs. market over the first quarter) and requires an average holding period of 2-3 years before performance starts to revert and loses are re-captured.

In the past, some premium-rated firms have delivered significant outperformance as they grow into their multiples. But on an average P/E of 28x, GS analysis shows that c.70% of them have underperformed.

So GS has provided some guidance above as to what HAS NOT worked for investors, I have some other research by US based fund management group, Tweedy Brown, on what has worked. The following is my summary from a booklet termed simply "What has worked in Investing" published by Tweedy Brown Company LLC in 1992 and republished in 2009. (http://www.tweedy.com/resources/library_docs/papers/WhatHasWorkedFundVersionWeb.pdf)

Tweedy Brown put together this booklet based upon numerous studies written by different investors and academics based on global data. The basic findings will be no surprise to value investors nor to Tweedy Brown. I have included their summary paragraph below:

*“ In addition to the confirmation provided by our own historical investment results spanning nearly 50 years, the extensive studies described in this booklet, in our judgment, have empirically confirmed that the fundamental approach to security analysis developed by Benjamin Graham, and long practiced by Tweedy, Browne, produces attractive long-term rates of return. Most investments in Tweedy, Browne portfolios have had, and continue to have, at the time of purchase one or more of the following characteristics:”*

1. Low Price in Relation to Asset Value or Equity. Stocks priced at less than book value (equity) are purchased on the assumption that, in time, their market price will reflect at least their stated book value; this is a combination of purchased and earned assets. From time to time, we also have been able to find stocks selling at discounts to net current assets (i.e., cash and other assets which can be turned into cash within one year, such as accounts receivable and inventory, less all liabilities), or stocks trading at significant discounts to net tangible assets. These are hard assets such as cash, land and buildings, stock that can be liquidated relatively easily.

2. Low Price in Relation to Earnings Stocks bought at low price/earnings (P/E) ratios afford higher earnings yields than stocks bought at higher ratios of price-to-earnings. The earnings yield is the yield which shareholders would receive if all the earnings were paid out as a dividend. Benjamin Graham recommended investing in companies whose earnings yield was 200% of the yield on AAA bonds. Investing in stocks that are priced low in relation to earnings does not preclude investments in companies whose earnings are expected to grow in the future. To paraphrase Warren Buffett, “value” and “growth” are joined at the hip. A company priced low in relation to earnings, whose earnings are expected to grow, is preferable to a similarly priced company whose earnings are not expected to grow. Price is the key. Included within this broad low price in relation to earnings category are high dividend yields and low prices in relation to cash flow (earnings plus depreciation expense).

3. A Significant Pattern of Purchases by One or More Insiders (Officers and Directors) Officers, directors and large shareholders often buy their own company’s stock when it is depressed. It stands to reason that insiders understand a business, its value and its prospects better than just about anyone else so when we seeing them

buy stock either for themselves or via a buyback, we take notice. It's a good indication (but not a guarantee) of value.

*4. A Significant Decline in a Stock's Price A fall in price is often accompanied by a decline in earnings or an earnings disappointment. Reversion to the mean is almost a law of nature with respect to company performance. We have found that, more often than not, companies whose recent performance has been poor tend to perk up and improve on top of that recent performance usually results in negative sentiment which is a required ingredient for attractive value to be created.*

*5. Small Market Capitalization The majority of analysis in the stockmarket is foccussed on big companies. As we go down the capitalisation scale, companies become less and less looked at by professional investors, stockbrokers etc. This lack of attention often leads to lower P/E s and therefore better value. Small companies also possess better capacity to grow and are more likely to get taken over.*

These long-term factors are the backbone of our investment process. We expect to see at least one of these attributes in the stocks we own shares in and these factors to provide attractive investment performance over time.